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Employee Benefit Plan Review

When the Leopard Changes Its Spots: An Employer's Change in Status Imperils Its Eligible 457(b) Plan

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Imagine if a minor shift in your organization's status – something seemingly superficial, like the spots of a leopard – could lead to serious financial upheaval. For sponsors of eligible 457(b) plans, this scenario is all too real. If the employer-sponsor of an eligible 457(b) plan changes its status as a governmental or tax-exempt entity, the eligible 457(b) plan will become an ineligible 457(f) plan, with potentially drastic consequences for participants. An employer faced with a change in status must be alert to this problem and take action before the status change occurs.

Types of 457 Plans

Internal Revenue Code (Code) Sec. 457 covers two types of plans, eligible 457(b) plans and ineligible 457(f) plans. Code Sec. 457(b) also divides eligible 457(b) plans into two types, eligible 457(b) plans sponsored by a governmental employer (G-457(b) Plans) and eligible 457(b) plans sponsored by a tax-exempt employer (TE-457(b) Plans).[1]

The rules for G-457(b) Plans and TE-457(b) Plans are different and sometimes conflicting. All eligible 457(b) plans must comply with the general rules under Code Sec. 457(b). In addition, an eligible 457(b) plan sponsored by a governmental employer must comply with the rules for a G-457(b) Plan, and an eligible 457(b) plan sponsored by a tax-exempt employer must comply with the rules for a TE-457(b) Plan. If an eligible G-457(b) Plan or TE-457(b) Plan does not comply with the applicable set of rules, it becomes an ineligible 457(f) plan.

What Happens When an Eligible 457(b) Plan Becomes an Ineligible 457(f) Plan?

When a 457(b) plan becomes a 457(f) plan, plan participants are put in a very bad spot:

- The present value of participant accounts[2] held by the plan become taxable when they are no longer subject to a substantial risk of forfeiture; however, subsequent additional earnings are taxed when paid or made available to the participant.
- Under the terms of the eligible 457(b) plan, participant accounts generally may not be paid until a participant terminates employment.[3]
- Since amounts deferred to an eligible 457(b) plan are normally not subject to a substantial risk of forfeiture (such as a vesting schedule), participant accounts become taxable but not distributable.

- The participant is thus faced with a tax liability but without cash available from the plan to pay it.

What Happens When The Plan Sponsor Changes Its Status?

When an employer sponsoring a G-457(b) Plan ceases to be a governmental employer, or when an employer sponsoring a TE-457(b) Plan ceases to be a tax-exempt employer, the employer's 457(b) plan in both cases will not be in compliance with the applicable 457(b) plan rules as soon as the status change occurs. At that moment, the plan will cease to be an eligible 457(b) plan and become an ineligible 457(f) plan, with the adverse tax consequences for plan participants described above.

The same applies when the employer changes from a governmental employer to a tax-exempt employer, or vice versa, because one type of eligible 457(b) plan (G-457(b) Plan or TE-457(b) Plan) cannot be converted or merged into the other type.

Is There Any Way to Avoid This Horrible Outcome?

There are two ways to avoid the adverse tax consequences for participants due to the employer's change in status, one of which is only available for a G-457(b) Plan.

1. A G-457(b) Plan Can Transfer Its Assets to Another G-457(b) Plan Within the Same State

All assets of a G-457(b) Plan can be transferred to another G-457(b) sponsored by a governmental entity within the same state. For purposes of the asset transfer, the transferring employer is considered to the be same employer as the receiving employer. As a result, there is no requirement that participants have a severance from employment with the transferring employer.[4]

The following additional requirements must be met for an in-state plan-to-plan transfer between G-457(b) Plans:

- The transferring and receiving plans must allow for such transfers;
- Amounts transferred for each participant must be the same before and after the transfer; and
- Participants whose plan accounts are transferred may not make deferrals to the receiving plan unless they perform services for the entity maintaining the receiving plan.[5]

2. A G-457(b) Plan or TE-457(b) Plan Can Be Terminated

Both G-457(b) Plans and TE-457(b) Plans can be terminated, if the plan allows (or is amended to allow) the plan to be terminated. If the plan is terminated, the tax consequences are determined in accordance with Treas. Reg. § 1.457-10(a), which provides that:

- For both G-457(b) Plans and TE-457(b) Plans, termination distributions are treated as if they are made by an eligible 457(b) plan, so long as all plan accounts are distributed as soon as administratively practicable (generally within 12 months of the termination date).
- Only termination distributions from a G-457(b) Plan are eligible for rollover. Termination distributions from a TE-457(b) plan are not eligible for rollover (not even to another TE-457(b) Plan or to a G-457(b) Plan). They must be paid to the plan participants as taxable distributions.

While not an ideal solution, terminating the G-457(b) or TE-457(b) Plan will at least give Plan participants cash from their termination distribution to pay their income tax liability.

The 457(b) regulations do not provide guidance about the mechanics of 457(b) plan terminations, except that distributions should be done as soon as administratively practicable, as noted above. In particular, no guidance has been given about when termination resolutions must be adopted or on what date the termination must be effective. Can the resolution adoption date or the termination effective date be after the employer's change in status or must they be before? We do not know. So, the best approach is to adopt termination resolutions which provide for a termination date prior to the change in status, even though termination distributions may be made after.

Get Your Ducks In A Row Before The Employer's Status Change Occurs

An employer is not likely to change its status as a tax-exempt or governmental employer overnight. If a status change is on the horizon, the employer should decide as soon as possible whether to terminate the eligible 457(b) plan (or, for a G-457(b) Plan, transfer its assets to another G-457(b) Plan within the same state), inform the plan's participants well in advance, and take action on the termination (or transfer) decision prior to the status change.

Notes

1. To make this distinction even clearer, Code sec. 457(e)(1)(B) defines a tax-exempt eligible employer as "any other organization (*other than a governmental unit*) exempt from tax under this subtitle." (Emphasis added.)
2. Assets attributable to a particular participant are usually called "participant accounts" for both G-457(b) Plans and TE-457(b) Plans, even though, technically, a TE-457(b) Plan's assets are only attributed to particular participants for bookkeeping purposes.
3. There are some exceptions to this general rule. A distribution for an unforeseeable emergency and distribution of small accounts prior to termination of employment under certain circumstances may be allowed by the plan. In addition, an eligible 457(b) plan must comply with the minimum required distribution rules and the plan administrator may make a distribution to comply with a qualified domestic relations order.

4. Plan-to-plan transfers are allowed for TE-457(b) Plans, but only if participants have a severance from employment with the transferring employer. This requirement usually makes the plan-to-plan transfer option unavailable in an employer status change situation.

5. That is, even though the transferring and receiving employers are considered the same employer for purposes of the asset transfer, they are not considered the same employer for purposes of eligibility to make deferrals to the receiving plan.

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